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No. 06-1413

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IN THE

Supreme Court of the United States

MEADWESTVACO CORPORATION, successor in interest to THE MEAD CORPORATION,
Petitioner,

v.

ILLINOIS DEPARTMENT OF REVENUE, DIRECTOR OF THE ILLINOIS DEPARTMENT OF REVENUE, and TREASURER OF THE STATE OF ILLINOIS,
Respondents.

On Petition for a Writ of Certiorari to the Appellate Court of Illinois

BRIEF OF *AMICUS CURIAE* COUNCIL ON STATE TAXATION IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Whether the "operational" test of *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992), bars a non-domiciliary state from taxing gain realized on the sale of a non-unitary business when that business was unrelated to the selling company's business and was not utilized as an investment by the selling company to generate funds for its operations.

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BRIEF OF *AMICUS CURIAE* COUNCIL ON STATE TAXATION IN SUPPORT OF PETITIONER

INTEREST OF *AMICUS CURIAE*

This brief *amicus curiae* in support of petitioner is filed on behalf of the Council On State Taxation ("COST") representing many of the largest businesses in our nation's state and local economies.[1]

[1] No counsel for a party authored this brief in whole or in part, and no person or entity other than *amicus curiae* has made a monetary contribution to the preparation or submission of this brief. Written consent of all parties to the filing of this brief has been obtained and filed with the Clerk of this Court.

COST is a non-profit trade association formed in 1969 to promote equitable and nondiscriminatory state and local taxation of multi-jurisdictional business entities. COST represents nearly 600 of the largest multistate businesses in the United States, including companies in every industry. COST's members are concerned that Illinois' effort to tax the gain on the sale of a non-unitary, non-operational line of business will subject taxpayers to inconsistent and unconstitutional taxation. COST's members are also concerned that left unchecked Illinois' approach to taxing all income will lead other states to adopt similarly unsound theories of taxation, exacerbating multiple taxation of the same income.

The present case involves Illinois' attempt to tax the gain on Petitioner Mead's sale of its investment in Lexis/Nexis, an independent, non-unitary business which it held as an investment for twenty six years. While the decision below concluded that Lexis/Nexis and Mead did not share a unitary relationship, it also concluded that the gain on sale of the business was apportionable income subject to tax. COST members routinely buy and sell investment subsidiaries, lines of business, and divisions of their companies. The frequency of these transactions and the large dollar amounts at stake (in this case a $1 billion gain) hyper-accentuate the importance of the rules for determining whether gains on such sales are apportionable income subject to tax by non-domiciliary jurisdictions. Certainty and protection against multiple taxation of such gains are critically important issues to all of COST's membership.

SUMMARY OF ARGUMENT

Illinois has violated this Court's rules for determining whether income from the sale of an asset can be subjected to tax by a non-domiciliary state. As set forth by this Court in *Allied-Signal, Inc. v. Director, Division of Taxation,* 504 U.S. 768 (1992), non-domiciliary states are only allowed to tax

income from the sale of a non-unitary asset if the asset served an operational function. Left unchallenged, the Illinois decision will eviscerate this Court's operational test. Virtually all income will thus become subject to apportionment and multiple taxation by the states.

ARGUMENT

I. *ALLIED-SIGNAL* APPLIES AN OPERATIONAL TEST FOR TAXATION OF NON-UNITARY INCOME

The taxation of multistate activity, and in particular the rules by which non-domiciliary states may tax income from the liquidation or sale of major assets, has routinely attracted the attention of this Court. This Court's guidance sets the constitutional boundaries for fair taxation of businesses whose activities cross state lines. By doing so the Court has created a set of rules which protect interstate commerce from discrimination and which provide clear guidance such that state and local taxes do not unlawfully impede economic growth. While the rules of state taxation were not always clear, this Court brought a measure of certainty to the arena of state tax in the landmark case of *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont*, 445 U.S. 425, 439 (1980), where it clarified that "[The] linchpin of apportionability in the field of state income taxation is the unitary-business principle." See also, *Exxon Corp. v. Department of revenue of Wisconsin*, 447 U.S. 207 (1980).

Two years later the concept of the unitary business enterprise was further clarified in two cases decided on the same day, *ASARCO Inc. v. Idaho State Tax Commission*, 458 U.S. 307 (1982) and *F. W. Woolworth v. Taxation & Revenue Department of New Mexico*, 458 U.S. 354 (1982). In these two decisions the Court struck down attempts by two states to tax an apportioned share of income which was—similar to the present case—derived from a non-unitary business. In

reaching its decision the Court indicated that actual, and not merely potential, control of another enterprise is required to establish a unitary relationship, and further emphasized that a unitary inquiry requires a review of three factors: "(1) functional integration; (2) centralization of management; and (3) economies of scale." *Id.* at 362, 364.

At a high level these three cases stand for the proposition that apportionability of income is tied directly to whether the income stems from a unitary function of the business sought to be taxed; in other words a state need not attempt to isolate the intrastate income-producing activities from the rest of the business; it may tax an apportioned sum of the corporation's multistate business if the business is unitary. *Allied-Signal* at 778.

Ten years after *ASARCO* and *Woolworth*, and in response to an effort by New Jersey to argue that all income was subject to apportionment[2], this Court upheld the unitary principle, acknowledging an exception where income from a non-unitary enterprise might be apportionable—if "the capital transaction serve an operational rather than an investment function." *Allied-Signal* at 787. It is the application of this standard that should determine the outcome of this case.

In providing the possibility that non-unitary income could be subject to apportionment this Court articulated the nature of the operational test. While *Allied-Signal* does not list a series of specific factors to consider under the operational test, its analysis is clear that the test focuses on whether the

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[2] In *Allied-Signal*, this Court specifically declined the invitation of the State of New Jersey that "the unitary business principle must be abandoned in its entirety, arguing that a nondomiciliary State should be permitted 'to apportion all the income of a separate multistate corporate taxpayer.'" *Allied-Signal* at 784. The Court rejected the idea that all income of an enterprise should be taxable in every state; an idea which it acknowledged would obliterate the apportionable income concept. *Id.*

asset generating the income was utilized directly in the selling company's business, or whether it was utilized for investment purposes to fund the day-to-day working capital and operations of the selling company. *Id.* at 787, 789-90. Only if one of these functions is met can the income be determined to be operational and subject to tax by a non-domiciliary jurisdiction.

II. ILLINOIS BLURS THE OPERATIONAL AND INVESTMENT TESTS OF *ALLIED-SIGNAL* SUCH THAT ALL INCOME WOULD BE OPERATIONAL

The Appellate Court of Illinois erroneously adopted its own test in place of the operational analysis required by *Allied-Signal*. Although the trial court concluded that the operations of Mead and Lexis were not unitary—a ruling left undisturbed—the Appellate Court of Illinois focused on a series of inappropriate and result-oriented factors intended to accomplish implicitly what New Jersey attempted explicitly in *Allied-Signal*—to eliminate any limitations on apportionment.

As described below, the factors utilized by Illinois to conclude that the gain was apportionable disregard the necessary operational focus—whether the asset was used in the same line of business as the company that sold it or whether the asset was analogous to working capital. By substituting its own factors the Illinois court instead focuses the analysis on criteria that would support the conclusion that the gain on sale of *any* investment subsidiary be subject to apportionment. In a rather self-serving fashion the court below evaluates factors that exist as a matter of normal business practice for hundreds of thousands of corporate investments and which make the elimination of non-apportionable income a fait accompli.

Application of Illinois' factors (instead of this Court's operational requirement) will result in treating all but an insignificant minority of business holdings as subject to tax. As demonstrated below, the Appellate Court of Illinois considered factors which have no bearing on the operational test adopted by this Court. Each of the stated reasons for the holding simply blur the operational and investment tests together in an attempt to conclude that all investment income is apportionable. The Opinion of the Appellate Court of Illinois ("*Op.*"), includes the following factors which, as also set out below, have no bearing on whether the asset being held is operational:

(i) "Mead considered Lexis/Nexis in its strategic planning, particularly in the allocation of its resources." *Op.* at 117.

Strategic planning about asset holdings, including a determination of where a parent company should invest additional resources, reflects analytic thought about the asset owner's financial investment strategy and thus supports a conclusion that the corporate holding serves an investment purpose, not an operational purpose.

(ii) "Mead was 100% owner of Lexis/Nexis." *Op.* at 118.

100% ownership of a subsidiary does not create a unitary relationship, as was conceded below, nor does it help demonstrate that the asset serves an operational purpose. Corporations buy and sell subsidiaries, divisions and lines of business every day. Some such transactions may be for operational synergy; others serve strictly an investment purchase—to hedge against market conditions, or simply to invest excess capital. The fact that Mead owned Lexis/Nexis for many years does not demonstrate an operational relationship, but, consistent with Mead's Annual Report and 10-K, demonstrates that Mead had made a long term investment in

Lexis/Nexis and was not using it as a form of short term working capital.

(iii) "Mead developed Lexis/Nexis by contributing capital support until it became profitable." *Op.* at 118.

The fact that an investor would contribute additional working capital to one of its corporate holdings demonstrates sound investment management designed to guard the investment from capital shortfalls or promote the growth of that investment. This factor demonstrates an investment management strategy, not an operational relationship.

(iv) "Mead continued to approve major capital expenditures by Lexis/Nexis." *Op.* at 118.

The fact that an investor retains decision-making power over major capital expenditures again demonstrates sound investment management designed to ensure that the investment owner's interests are adequately protected.

(v) Mead "manipulated Lexis/Nexis' business organization, treating it as either a division or a corporate subsidiary". *Op.* at 118.

Switching corporate form or structure is done thousands of time each day by companies throughout the country. The tax and non-tax related reasons for routine changes in corporate structure are nearly infinite.

(vi) "Mead retained tax benefits and control over Lexis/Nexis' excess cash." *Op.* at 118.

It should go without saying that investors put their money in investments with the goal of retaining tax benefits and excess cash produced by the investment.

(vii) Mead, in its 1993 annual report, "identified itself as 'the developer of the world's leading electronic information retrieval services for law, patents, accounting, finance, news and business informa-

> tion'"; and, in its "1993 10-K form, Mead described itself as engaged in electronic publishing and included Lexis/Nexis in its discussion of business segments rather than its 'investees.'" *Op.* at 118.

Corporate Annual Reports and 10-K's aim to provide shareholders with information about the company itself as well as information about all of its investment holdings. The fact that the Annual Report and 10K identified the company "itself" as being in the electronic information business is simply a reflection of the fact that the report discloses all significant holdings, divisions and lines of business of the combined group of related entities. This cannot be a factor in determining whether the corporate holding is operational.

* * * *

The factors used, when taken together, describe activities that any investor would sensibly conduct to protect asset value. As such, those factors blur the operational analysis inextricably with investment function analysis. At the heart of the Illinois court's "operational" analysis, in light of common investment practices, is a goal of subjecting to tax the gain on sale of *any* investment if the state can show that the investor exercised normal due diligence; exercised some level of control; engaged in strategic planning; continued expansion of the investment if necessary; controlled how the investment is held or titled; decided whether to retain tax benefits or excess cash created by the investment; and, worst of all, if the investor managed to do well by the investment and noted that fact in its Annual Report or 10-K.

The "operational" activities that Illinois considers relevant are synonymous with normal investment practices reflecting the due diligence necessary to protect and nurture the value of any investment. This type of stewardship is not symptomatic of the control and utilization inherent in the operational relationship required by *Allied-Signal*.

Illinois should not be allowed to blur operational analysis simply by substituting factors that demonstrate sound investment practice. To do so obliterates the operational standard altogether and will have the effect of subjecting investment gains from non-unitary holdings to multiple and discriminatory taxation.

CONCLUSION

Allied-Signal is a critical case establishing the outer reach of a state's ability to tax income by limiting it to those activities that bear a substantial relationship to the operations of the investor corporation in the state.

The decision of the Appellate Court of Illinois undercuts that standard, exposing companies to unlimited apportionment and multiple taxation, and creating uncertainty among the states as to their proper constitutional limitations.

The petition for writ of certiorari should be granted.

Respectfully submitted,

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